Three calls for the eurozone

We foresee another year of economic stagnation in the eurozone and rate cuts by the European Central Bank in mid-2024. Meanwhile, uneven fiscal policy across the bloc could lead to widening spreads in sovereign bond markets

We expect the ECB to start cutting rates by the summer

1 Another year of stagnation as private consumption disappoints

The energy crisis caused a sharp contraction in private consumption in late 2022, from which it has so far not recovered. While real wage growth is turning positive again, we remain cautious on the outlook for spending, pencilling in just 0.8% growth for 2024 (compared to a forecast of 1.6% by the European Central Bank and 1.2% by the European Commission). Consumption growth is likely to be limited by the turn in the labour market, with a gradual increase in unemployment limiting aggregate income growth. This generally also increases precautionary savings. Meanwhile, higher interest rates will increase mortgage payments and make buying on credit harder. Even with a much more benign inflation backdrop, we expect eurozone consumption growth to remain subdued in 2024, keeping GDP growth below 0.5%.

2 Uneven fiscal policy as Germany moves towards austerity

Fiscal policy has always been a potential risk factor for the eurozone. The recent ruling by the German Constitutional Court will put new tensions on fiscal policy and the fiscal framework in the eurozone. It is hard to see how a German government, fighting for its political survival and implementing new austerity measures at home, will agree to a relaxation of the eurozone's fiscal rules, a.k.a the Stability and Growth Pact (SGP). The Dutch election outcome might also make a compromise on the SGP more difficult, keeping the old rules more or less in place. At the same time, due to the upcoming European Elections, the European Commission is unlikely to start any corrective action or measures against countries with fiscal deficits deemed too high before the summer. All of this means very uneven fiscal policy across the eurozone. While Germany will embark on self-inflicted austerity, the rest of the eurozone looks set to delay significant consolidation efforts. This is likely to lead to widening spreads in the sovereign bond markets in the course of 2024.

3 Disinflation to trigger ECB rate cut before the summer

Just as the ECB underestimated the strength and pace of surging inflation in 2021 and 2022, so it is now at risk of underestimating the pace of disinflation. Headline inflation has already come down to around 3%, wage growth should plateau in the first few months of 2024, and the full impact of the ECB's monetary tightening this year will continue to unfold in 2024. The disinflation of 2023 was mainly the result of energy and fiscal policy base effects. The disinflation of 2024 is likely to be the result of ECB tightening. As a consequence, we expect headline inflation to hover around 3% in 2024 and core inflation to drop to 2.3% by the end of the year. With a weaker-than-expected eurozone economy, the 2024 disinflation will allow the ECB to take its foot off the monetary policy brake. We expect the ECB to start cutting rates by the summer, and to cut by a total of 75bp next year.

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